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INVESTMENT UPDATE

Let's get one thing straight: We're capitalists. We believe, very strongly, that after casting around for a few thousand years on this spinning orb, mankind found that the best way to organize an economy (if not a society) was through capitalism. Capitalism, especially when combined with a liberal democracy ("liberal" meaning free choice when it comes to civil liberties and political freedom) provides incentives to work hard, distributes the "means of production" to their best uses, and rewards intelligent risk-taking.

Yes, capitalism has its weaknesses. It addresses macro issues very well, but capitalism can be very tough on individuals. When funds dry up and capital flees from one enterprise to another, there are winners and losers; and while the economy as a whole should profit from the free and efficient re-allocation of capital, some part of the population will suffer loss of employment, income and wealth. But capitalism tells us that an economic rising tide will lift all boats, and that a capitalistic economy provides the opportunity for the losers to regain their lost wealth by keeping the door open to employment and access to capital.

In capitalism, the central government has an important role to play—it must ensure that laws are in place to support and enforce the ownership of property. Laws should also encourage competition and ensure that business entities all play by the same rules. Obviously, there are many other considerations, laws, and regulations when it comes to the proper involvement of the state; suffice to say that most fall under the heading of "maintaining a level playing field."

One other main consideration, however, in any modern economy is how to tax the profits of businesses. In a perfect world, there would be no taxes, and profits would flow directly through to the owners of the business in compensation for committing capital to a risky enterprise. But the reality is that the laws and regulations which are in place to support businesses (as well as the defense and other social services necessary to sustain the country in which these commercial enterprises exist) all come at a price, and that price is paid, in part, by taxes on businesses.

We know that economies succeed, especially over the long term, when tax and regulatory policy work to maintain economic freedom. How does one measure "economic freedom," you ask—fortunately, the Heritage Foundation and *The Wall Street Journal*, working together, produce and publish the Economic Freedom Index, an annual survey of the world's developed (and some developing) economies. The EFI ranks countries' economic freedom based on four major categories: rule of law, limited government, regulatory efficiency, and open markets. They explain it this way: "In an economically free society, individuals are free to work, produce, consume, and invest in any way they please, with that freedom both protected by the state and unconstrained by the state."

Unfortunately, the US is losing ground in this survey, having fallen to tenth place in the 2013 survey, behind such well-known bastions of free-market-ism as New Zealand, Chile and (gulp) Mauritius. The US is in the "Mostly Free" group, with an index rating of 76.0, down from 80.9 in 2008, when we ranked fifth in the world. Looking more closely at the survey, we see that the US has suffered in the aftermath of the 2008 financial crisis, with measures such as monetary freedom and government spending trending down. That's no surprise, as the fiscal and monetary stimulus programs which have been put in place to encourage US economic growth over the past half-decade have added massively to the US's public debt burden, as well as artificially driving down the cost of credit by way of the Fed's quantitative easing programs.

As die-hard free-marketers, we cringe when we see the US dropping in this survey. We like to think that nobody runs a more efficient, fair, and free economy than us, but the numbers say otherwise. We even are willing to accept, at least for a short period, the fact that our fiscal imbalances over the past half-decade were forced on us in order to keep the US and global economies from collapsing. It's noble, yet politically impossible, in this day and age for policymakers (even in a strongly-capitalistic society like ours) to let the markets deal with high unemployment and social suffering with no help from the state. We see these results as temporary, and have some confidence that US policy will get back on track once the economy strengthens.

But there's another measure in the survey that we view with more than a little alarm: The US has also slipped in the "Freedom from corruption" measure. In 2013, the US ranked 24th in freedom from corruption, down from 17th in 2007, and way down from 1996, when the US ranked first. Is the US becoming corrupt? What the heck is going on? According to the Heritage Foundation's website, *"In advanced economies, corruption often takes more subtle forms, involving special subsidies or tax privileges for elites, abuses of government*

contracting, cronyism, and selective bailouts."

There are no details of how these corruption factors are measured and weighted, but we can easily think of one notorious example of "tax privileges for elites," and unfortunately, it's in our own backyard. We're speaking of the loophole for "carried interest" that's exploited by private equity and certain hedge funds, where taxes on income are levied not at the marginal income tax rate, but at the much lower capital gains rate. Without going into all the gory details, here how it works: First, a fund is set up by the private equity manager, who acts as the general partner and sells (typically) 80% of the ownership to investors who are limited partners, retaining the other 20% for itself. In most cases, the general partner/private equity manager gets a 2% management fee as well for managing the partnership. The 80% that's invested by the limited partners is ordinarily all the capital that goes into the fund; the private equity manager puts in essentially nothing except for its expertise at finding companies to buy which can be turned around for a profit. In other words, if you buy into a private equity fund, you and the other limited partners will put in 100% of the capital and get only 80% of the profits, less a 2% annual management fee.

If you're thinking "That's a pretty good deal for the private equity guys," you'd be right, but that's only half of it. The US tax laws treat the income of these private equity companies as capital gains, under something called "carried interest." From 2003 until the beginning of 2013 (when it was raised to a still-low 20% rate) capital gains taxes have been charged at 15%—less than half the marginal income tax rate for high-income individuals, and make no mistake, essentially all these private equity guys, from the 2% management fees alone (approximately *ten times higher* than your average fixed income management fee), are in the top tax bracket. Private equity managers are in the investment management business, selling their services to institutions and high-net worth individuals, just as we, and many other fixed income, equity, real estate, and managers of other asset classes do, yet their income gets charged at a tax rate roughly half of ours due simply to the exploitation of a loophole that was never designed to benefit them in the first place.

The "corruption" part comes from the way these highly successful firms, with high-profile multi-millionaire owners, have curried favor with lawmakers to keep the carried interest loophole on the books. Congress originally lowered the capital gains tax to encourage individuals to invest in the US stock market, to broaden corporate ownership, spur savings and provide capital, knowing that if investors took intelligent risks and saw their investments rise in value, they would be rewarded for their risk-taking by paying a lower tax rate. For a while, the private equity funds flew below the radar, taking advantage of the loophole to feather their nests, while quietly courting policymakers and whispering how important it was to keep tax rates low.

But the cat is well and truly out of the bag now, with Mitt Romney's disclosure of his 14% effective tax rate doing his private equity buddies no favors by highlighting the issue, while Warren Buffett made a point of noting the disparity between his own ultra-low effective tax rate and the higher rate paid by his secretary. And while no one pretends that taxing hedge funds and private equity managers at a higher effective rate would balance the federal budget, the imbalanced and tilted playing field is a thumb in the eye to millions of Americans who have no lucrative loopholes to shelter their hard-earned wages. Nevertheless, the war of words rages on, with Blackstone's Steve Schwarzman invoking Adolf Hitler's name when protesting the call for the elimination of the carried interest loophole.

There is the additional question of whether private equity firms are good for America's long-term economic health. Private equity firms use other people's money—investors and bankers—to buy companies, load them up with debt, and flip them for a profit. Most aren't really in it for the long haul; their goal is to cut costs and improve profitability just long enough to be able to re-sell the company for a profit. This normally means that there will be significant job cuts, which have a negative impact both for those who've been laid off as well as those who are left behind, who often have to do their job and part of someone else's, too. This is good for short-term productivity, but not for long-term employee satisfaction. And while we cannot blame private equity firms for the fact that US manufacturing jobs, as a percentage of the US economy, have been cut in half over the past 30 years, they have played a part, as outsourcing labor can provide immediate short-term cost-cutting benefits.

Efficiency is good, and companies with bloated cost structures and poor management will fall under the knife one way or the other, and that's how it should be. But the focus should be on building companies who can compete over the long-run, and we have concerns about the emphasis on short-term results that drive the private equity business. We also object, as corporate bond holders, any time the acquisition of a company is financed primarily with debt, since it leaves the company in a weakened financial state, making our investments far less secure. In our market, the mere rumor of private equity involvement in one of our corporate bond holdings can send the price of a company's bonds into a downward spiral.

The real blame lies with Congress, which has the responsibility to structure the tax code so that it provides the right incentives for business owners to focus on the long-term health of their companies, and in so doing, helping to sustain US economic growth over the long haul. Tax policies should not be based on how much money a politician takes in from well-heeled special interest groups whose motivations are, by definition, much more narrowly-focused.